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No. 80- 941

IN THE

Supreme Court of The United States

OCTOBER TERM, 1980

LOMAS & NETTLETON FINANCIAL CORPORATION, et al.,

Petitioners,

v.

GEARLD CLARK, et al.,

Respondents.

ON PETITION FOR WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

RESPONDENTS' BRIEF IN OPPOSITION

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QUESTION PRESENTED

WHETHER THE BOARD OF DIRECTORS OF BOOTH, INC. POSSESSED THE AUTHORITY TO COMPROMISE THE PLAINTIFF SHAREHOLDERS' DERIVATIVE CLAIMS WHERE SUCH BOARD OF DIRECTORS STOOD IN A DUAL RELATION THAT PREVENTED AN UNPREJUDICED EXERCISE OF JUDGMENT.

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The Respondents, Gearld Clark, Tom Burden, Ronald Brandow, Robert Burnside and Wayne Burnside, respectfully request that

this Court deny the petition for writ of certiorari, seeking review of the Fifth Circuit's opinion in this case. That opinion is reported at 625 F.2d 49.

STATEMENT OF THE CASE

Petitioners' Statement of the Case contains few record references and fails to accurately set forth the nature of the case. Accordingly, Respondents direct the Court's attention to the statement of the case contained in the Court of Appeals opinion in this cause as set forth in Appendix A to the petition at pages A-1 through A-4, which statement of the case is incorporated herein by reference as if set out in full. Respondents will hereinafter point out the factual inaccuracies contained in petitioners' statement of the case and provide additional facts not set forth in the opinion of the Fifth Circuit.

Petitioners totally mischaracterize the events leading to the settlement agreement entered into among the Defendants in this case. At the conclusion of the pre-trial hearing held on January 9, 1978, the trial court (rather than Plaintiffs' counsel) suggested that the court participate in settlement discussions. (Defendants' appendix filed in the Fifth Circuit, Vol. IV, p. 995, hereinafter cited "D.A.") The Petitioners' assertion that "the Plaintiffs refused to consider any settlement of the corporate derivative claims without a simultaneous settlement of their individual claims" is incorrect. (Petition at p. 3). In the initial discussion with the court, Plaintiffs did not make a separate settlement demand with regard to the derivative claims, but in a subsequent discussion with the court, the Plaintiffs did make a separate

settlement offer with regard to the derivative claims. Further, there is no evidence that any of the Defendants offered to discuss or negotiate with Plaintiffs' counsel any settlement of the derivative claims without settlement of the individual claims.

Petitioners also assert that the "six non-defendant directors of Booth, Inc. . . . negotiated a settlement of the derivative action on behalf of the corporation." (Petition at p. 3) In truth and in fact, said directors never entered into any "negotiations", but instead, legal counsel for the corporation entered into the settlement agreement which was later approved by the Board of Directors based solely on the recommendation of such counsel. (D.A. Vol. IV, p. 1225 and Deposition of Ralph Osborn, Chairman of the Board, at p. 31-55). No

settlement discussions took place between the Plaintiffs and Defendants, but instead, the settlement was crafted by the defendants, including nominal Defendant Booth, Inc., without the knowledge or participation of the plaintiffs. The Defendants' settlement was presented to Plaintiffs' counsel as a fait accompli on the afternoon of January 10, 1978. (D.A. Vol. V, p. 1457).

The Fifth Circuit's statement of the case does not fully set forth the terms and effect of the settlement. The settlement agreement provides that Defendant Lomas & Nettleton Financial Corporation (LNFC) shall pay to Booth, Inc., $400,000.00 in cash and shall assign to Booth, Inc. 258,983 shares of common stock of Booth, Inc.; one or more other un-named Defendants shall pay to Booth, Inc. $15,000.00 in cash; Booth shall release all claims against all Defendants; Defendants

Hay, Rohnstedt, Sexton, Ray and Gardner waive any right of indemnification against Booth, Inc.; and Defendants Jack Booth, Glaze, Rucker, Whitmer and Tannery will not waive any claim against Booth, Inc. for indemnification of costs, expenses and attorneys' fees incurred in the litigation. (D.A. Vol. IV, pp. 1006-1012). One major effect of this settlement is to release Defendant Jack Booth from all liability, while at the same time conferring on him the benefits of (a) an increase in his control of the corporation from 45% to 50.4% of the outstanding shares and, (b) payment of all of his legal fees and expenses.

Another significant factual matter not referred to in the Fifth Circuit's opinion is the clear conflict of interest of the law firm purporting to represent Booth, Inc. The firm of Saner, Jack, Sallinger & Nichols

(hereinafter referred to as the "Saner firm") has been counsel of record for Booth, Inc. from the beginning of this action. But in addition, the Saner firm also served as counsel of record in this litigation for Defendants Jack Booth, Martin Whitmer and Fladger Tannery beginning on January 21, 1977, when it filed a Motion to Dismiss the derivative counts of Plaintiffs' Third Amended Complaint asserted against said individual Defendants. It was not until December 22, 1977, that the Saner firm moved to withdraw as counsel of record for said Defendants. Said motion was granted on December 27, 1977, only two weeks before the Saner firm entered into a settlement agreement on behalf of the corporation with these very Defendants. As a part of the settlement, these former clients of the Saner firm not only were released from all claims,

but the settlement provides that all of such Defendants would not waive any claims for indemnification from the corporation for their costs, expenses and attorneys fees in this litigation.

In addition, the record shows that the Saner firm has represented Defendant Jack Booth since 1943 and continues to perform legal services for Defendant Jack Booth. A partner of the Saner firm has been a director of Booth, Inc. since the merger of NCS Computing Corp. (NCS) and Booth, Inc. (Old Booth) in 1973 and had been a director of Old Booth continuously from 1950 to the date of the merger. (D.A. Vol. IV pp. 1020-1023 and Vol. I, p. 195). Under the terms of the settlement crafted by the Saner firm, their client, Defendant Jack Booth directly benefits from the settlement by the increase in his control of the corporation from 45% of

the outstanding shares to approximately 50.4% of the outstanding shares. (Exhibit 7 to settlement hearing held on June 5, 1978).

The Fifth Circuit did not reach several issues presented for review by the Respondents herein, to wit: whether the Saner firm should have been disqualified from representing Booth, Inc.; whether the trial court violated Fifth Amendment due process rights by refusing to order Rule 23.1 settlement notice to be sent to pre-merger shareholders of NCS; whether the trial court violated constitutionally protected rights of free speech and association by entering a non-communication order; whether the trial court erroneously approved the settlement when the proponents had failed to show that there was no collusion in arriving at the compromise; and whether the settlement itself was fair, reasonable and and adequate.

Pertinent facts with regard to each of these matters will be set forth in connection with the argument hereinafter set forth.

ARGUMENT

REASONS FOR DENYING THE PETITION

I.

THE COURT OF APPEALS DECISION DOES NOT CONFLICT WITH THIS COURT'S HOLDING IN BURKS V. LASKER, 441 U.S. 471 (1979).

In Burks v. Lakser, 441 U.S. 471 (1979), this Court held that a two-step inquiry is involved in determining whether a disinterested, independent Board of Directors can terminate a derivative suit: (1) does applicable state law allow such termination; and if so, (2) whether such a state law rule is consistent with the policies of the federal law involved. In the case at bar,

the Fifth Circuit did not depart from the aforesaid decision and correctly held that the Board of Directors of Booth, Inc. is incompetent to terminate this derivative suit by reason of the dual relationship and conflict of interest of its directors under the facts of the case.

A. The Board of Directors was incompetent to terminate Respondents' derivative claims by reason of its conflict of interest.

It is generally held that the management of a corporation, including decisions of Board of Directors to pursue or abandon litigation, is entrusted to the corporation's Board of Directors and that business judgments made by the Board are not subject to review. However, as noted by the Fifth Circuit in this case, "the power to control corporate litigation presupposes that the

directors have no interest in its exercise." 625 F.2d at 52. Indeed, this Court has held that where the directors "stand in a dual relation which prevents an unprejudiced exercise of judgment", the Board's business judgment is reviewable. See also, Galef v. Alexander, 615 F.2d 51, 58-61 (2d Cir. 1980); Maher v. Zapata Corp., 490 F.Supp. 348, 351 (S.D. Tex. 1980); Maldonado v. Flynn, 413 A.2d 1251, 1263 (Del. Ch. 1980). Thus, the initial inquiry in this case must go to the specific facts concerning the interest of the Board of Directors, unlike the situation in Burks where the directors were disinterested.

Beyond the fact that Defendants Jack Booth and LNFC together owned a majority of Booth's outstanding shares, it is undisputed that each and every director who approved the settlement was elected by the combined vote of said Defendants. The proxy statement disseminated in connection with the election

of the Board of Directors states that "both Jack J. Booth and Lomas & Nettleton Financial Corporation intend to vote their shares in favor of the election of the nine directors proposed by management." (Exhibit 7 to settlement hearing held June 5, 1978). In addition to controlling the Board, Defendant Jack Booth is the Chief Executive Officer of the company. (Osborn Dep., pp. 7-8). Even the Chairman of the Board, Ralph Osborn, reports to Jack Booth and owes his $200.00 per day consultant job to Mr. Booth. (Exhibits 457-461 to Tim Kirk Dep.). Director W.H. Jack had been personal legal counsel to Jack J. Booth for over thirty years; Director Charles E. Tedford is the president and founder of a major supplier of screw machine parts to Booth, Inc. (Booth, Inc. paid Tedford or his company $172,903.85 in 1976 and $113,809.60 in 1977); Director James Booth is Defendant Jack J. Booth's

brother; Director William C. Hall had been a director of Old Booth since 1959 and a director of Booth, Inc. after the merger up to the present. Thus, Defendants Jack Booth and LNFC directly and indirectly controlled the Board of Directors which approved the settlement.

Not only did the Board of Directors suffer from divided loyalties, but the Saner firm, which was advising the Board of Directors, also suffered from a conflict of interest. Said firm was not only counsel for Booth, Inc., but said firm also was counsel of record for Defendant Jack J. Booth from the date he was named as a defendant until only two weeks before the settlement was entered into. Even after withdrawing as counsel of record for Jack J. Booth, the Saner firm continued to act as Mr. Booth's counsel in other matters. The conflict of

interest of the Saner firm becomes even more crucial to the result of this case, since the approval of the proposed settlement by the Booth Board of Directors was based solely on the recommendation of the Saner firm. The Chairman of the Board, Mr. Osborn, testified that there was no discussion concerning the prospects of success in this litigation. (Osborn Dep. at p. 54). Instead, the Board of Directors merely accepted the Saner firm's recommendation that the settlement be approved. (Osborn Dep. at pp. 31-55).

Thus, the directors of Booth, Inc. are incompetent to terminate Respondents' derivative claims by reason of their conflict of interest. A majority of the directors who approved this settlement clearly were interested persons by reason of their relationship with Defendant Jack J. Booth and Defendant LNFC. Unlike the facts in Burks

v. Lasker, in the case at bar the directors purporting to exercise their business judgment were not disinterested. As held by the Fifth Circuit, "Jack Booth and LNFC wielded power to strip them [the directors] not only of directorates, but of officer and consultant positions as well." 625 F.2d at 53. Further, the sudden, hostile reaction of the corporation to the joinder of Jack J. Booth as a defendant in the case demonstrates the bias of the Board toward Defendant Jack Booth. See, e.g. Grynberg v. Farmer, [1980 Transfer Binder] CCH Fed. Sec. L. Rep. ¶97, 683 (D. Col. 1980); Note, The Business Judgment Rule In Derivative Suits Against Directors, 65 Cornell L. Rev. 600 (1980). In short, because of the conflict of interest of the directors in the case at bar, the Fifth Circuit properly held that the directors were incompetent to terminate Respondents' derivative suit.

B. The Board of Directors was incompetent to terminate Respondent's derivative claims by reason of the Defendants' control of the corporation.

Where, as here, the controlling shareholders are named Defendants, the directors elected by such shareholders are incompetent to compromise derivative claims against such defendant controlling shareholders. The Court of Appeals correctly decided that cases excusing the "demand" requirement of Rule 23.1, Fed. R. Civ. P., are applicable to the determination of whether the directors are incompetent to compromise derivative claims. It is generally held that where the controlling shareholders are named defendants, the futility of a demand on the Board of Directors to take action against the controlling shareholders is presumed. See Hyams v. Calumet & Hecla Mining Co., 221 F.

529, 538 (6th Cir. 1915); Abbe v. Goss, 411 F.Supp. 923, 924-25 (S.D.N.Y. 1979); In Re, Penn Central Securities Litigation, 367 F.Supp. 1158, 1164-65 (E.D.Pa. 1973); Cohen v. Industrial Finance Corp., 44 F.Supp. 491, 494 (S.D.N.Y. 1942), quoted in DeHaas v. Empire Petroleum Co., 286 F.Supp. 809, 814-15 (D.Colo. 1968), modified on other grounds, 435 F.2d 1223 (10th Cir. 1970). Further, in Zauber v. Murray Savings Assoc., 591 S.W.2d 932, 939 (Tex. Civ. App.-Dallas 1979, writ ref'd n.r.e.), a Texas court specifically held that where a demand on the Board of Directors is futile, the Board of Directors of the company is powerless to terminate the suit. In this regard, Texas law is in accordance with the law of Delaware. See Maldonado v. Flynn, supra.

In the case at bar, Defendant Jack Booth and LNFC owned 56% of the outstanding shares

of the company and it is undisputed that said shareholders determined the membership in the Board of Directors which approved the settlement. (Booth's April, 1977 proxy statement, Ex. 7 to settlement hearing held June 5, 1978). In addition, at least two separate demands were made on the Board of Directors of the company to take action, but both such demands were expressly or impliedly refused. (D.A., Vol. I, p. 7, 47, 84, 131, 137, 151; Dep. Exhibits 273 and 274). It was the Plaintiffs, not the corporation, who tenaciously pursued the claims in this litigation, doing so without assistance, financial or otherwise, from the corporation, and over the objection of the corporation when Plaintiffs sought to assert claims against Defendant Jack J. Booth. (Opposition of Booth, Inc. to Plaintiffs' Motion to Leave to File Third Amended Complaint, filed June 8, 1976). Thus, by reason of the control of

the Board of Directors by Defendants in this suit and the Board's refusal of the demands made by the Plaintiffs, the Board of Directors of Booth, Inc., is incompetent to terminate this litigation. See, e.g., Zauber v. Murray Savings Assoc., supra; Sonics International, Inc. v. Dorchester Enterprises, Inc., 593 S.W.2d 390 (Tex. Civ. App.-Dallas, no writ); See also, e.g., Maldonado v. Flynn, supra; Maher v. Zapata Corp., supra; Abella v. Universal Leaf Tobacco Co., 495 F.Supp. 713 (E.D.Va. 1980).

II.

THE COURT OF APPEALS' DECISION HOLDING THAT THE BOARD OF DIRECTORS WAS INCOMPETENT TO COMPROMISE RESPONDENTS' DERIVATIVE CLAIMS DOES NOT CONFLICT WITH UNITED STATES SUPREME COURT OR FIFTH CIRCUIT DECISIONS HOLDING THAT FRAUD SHOULD NOT BE PRESUMED.

Contrary to the assertion of the Petitioners, the Fifth Circuit opinion in this case does not conflict with Sanez v. Kennedy, 178 F.2d 417, 419 (5th Cir. 1949), in that the Fifth Circuit in this case did not hold that fraud was to be presumed. Instead, the Fifth Circuit held that the directors were incompetent to terminate this litigation under rules governing the settlement of derivative claims. In addition, the decision rendered in Sanez had absolutely nothing to do with the settlement of a derivative action, but instead, the per curiam opinion involved an allegation of fraud and collusion between counsel for the Defendants and the judge of the district court. 178 F.2d at 419. Hence, Sanez is clearly distinguishable from the case at bar.

Similarly, contrary to Petitioners' assertion, the Fifth Circuit did not

establish an "irrebutable presumption of non-defendant directors' fraud and wrong doing", but held instead, that where, under the specific circumstances of this case, including the bias of the directors toward defendant Jack Booth and the control of the Board of Directors by Defendants Jack Booth and LNFC, the directors were incompetent to compromise Respondents' derivative claims.

Since the cases cited by Petitioners are distinguishable and not in conflict with the Fifth Circuit's decision in this case, Petitioners' writ properly should be denied.

III.

THE COURT OF APPEALS DECISION DOES NOT CONFLICT WITH ANY FEDERAL POLICY IN CONNECTION WITH THE SETTLEMENT OF DERIVATIVE SUITS.

The Fifth Circuit's decision in no way contravenes federal judicial policy with

regard to the approval of derivative settlements. Instead, the Fifth Circuit's decision specifically recognizes that the role of the Court is to approve or to disapprove a settlement when the "case is settled by parties unbeholden to the alleged wrong-doers." 625 F.2d at 54. Under Rule 23.1, Fed. R. Civ. P., the court's role is to approve or disapprove a settlement entered into by the parties litigant, not to impose a "fair, reasonable and adequate" settlement on the parties. Petitioners urge this court to place a federal court in the position of substituting its own settlement terms for that of the litigating parties who are intimately aware of all aspects of the litigation. This has not been, and should not be, the position of the federal courts. The role of the courts under current statutes and rules is that of protector of the absent shareholders when a settlement by the proper

parties is brought before the court. Under current statutes and rules, there is absolutely no authority for the court to impose a settlement on the parties. Instead, if the proper parties are unable to arrive at a settlement themselves, then the case must proceed to trial on the merits for a determination by the court in accordance with the law and facts of the case. While settlements clearly are favored by the courts, there is no prior case law which would give the court the power to impose a settlement on the litigants.

IV.

PETITIONERS' ARGUMENT IS WITHOUT MERIT, WHETHER OR NOT THE DECISION BELOW WAS CORRECT, FOR THE REASON THAT THE COURT OF APPEALS DID NOT PASS ON SEVERAL ISSUES PRESENTED TO THAT COURT WHICH WOULD REQUIRE REVERSAL OF THE SETTLEMENT.

The Court of Appeals did not reach several issues raised by the Respondents in said court, which, and in addition to the issue determined by the Fifth Circuit, would require the settlement to be vacated.

A. The trial court erred in refusing to disqualify the Saner firm from representing Booth, Inc.

Prior to approval of the settlement of the case at bar, Respondents moved to disqualify the Saner firm from representing Booth, Inc. by reason of its conflict of interest as described hereinabove. The trial court denied Respondents' Motion to Disqualify. Where, as here, a single law firm represents both individual defendants and the corporation in a derivative action, such counsel must be disqualified as counsel for the corporation, even if counsel offers to withdraw its representation of the indi-

vidual defendants. See, e.g., Cannon v. U.S. Acoustics Corp., 398 F.Supp. 209 (N.D. Ill. 1975), aff'd in relevant part, 532 F.2d 1118 (7th Cir. 1976) (per curiam); Messing v. F.D.I., Inc., 439 F.Supp. 776 (D.N.J. 1977); Rowland v. LeMares Mut. Ins. Co., 230 N.W. 2d 905 (Iowa 1975).

B. The trial court's non-communication order violates constitutionally protected rights of free speech and association, and the trial court lacked authority to enter said order based on the record in this case and the applicable federal rules.

In connection with its tenative approval of the proposed settlement in this litigation, the trial court entered a non-communication order which provided, in part, as follows:

"All counsel herein are hereby forbidden to . . . communicate with any persons not

parties in a manner which may tend to misrepresent the status, purposes or fact of the action or orders herein."

Thus, the trial court placed a "prior restraint" on the first amendment freedoms of speech and association of counsel. As a "prior restraint", there is a "heavy presumption" against the order's validity. Nebraska Press Assn. v. Stuart, 427 U.S. 539 (1976) (and cases cited therein). In Rodgers v. United States Steel Corp., 508 F.2d 152 (3d Cir. 1975), the court struck down a local rule of the Western District of Pennsylvania which contained a broad, non-communication order similar to the one at issue herein. See, also, e.g., Bernard v. Gulf Oil Co., 619 F.2d 459 (5th Cir. 1980); Coles v. Marsh, 560 F.2d 186 (3d Cir. 1977); Chicago Council of Lawyers v. Bauer, 522 F.2d 242 (7th Cir. 1975), cert. denied, 427 U.S. 912.

C. The district court's refusal to order Rule 23.1 settlement notice to be sent

to pre-merger shareholders of NCS Computing Corp. violated fundamental Fifth Amendment due process rights.

The relief sought in the pleadings in this cause include recission and an unwinding of the merger of NCS Computing Corp. and Old Booth. This relief would return NCS to its position prior to the merger and accordingly, the pre-merger shareholders would benefit indirectly through their stock ownership in the pre-merger NCS Computing Corp. Thus, Respondents requested that the trial court send notice of the proposed settlement to the pre-merger shareholders who, under the pleadings, were clearly "interested parties". Such notice to "interested parties" has been held to be an elementary and fundamental requirement of due process. See, e.g., Mullane v. Central Hanover Bank & Trust Co., 339 U.S. 306, 314 (1950). The trial Court's

failure to give notice to pre-merger shareholders thus required reversal of the settlement.

D. The proponents of the settlement failed to show that the settlement was fair, reasonable and adequate.

As indicated in the opinion of the Fifth Circuit, the court expressly did not determine whether the settlement in this case was fair, reasonable and adequate. The settlement in the case at bar clearly was not fair, reasonable or adequate under the circumstances of this case. In particular, the settlement itself provides that Defendant Jack J. Booth, one of the wrong-doers, reap substantial benefit as a result of the settlement. It has been held that a settlement could not be approved where the Defendants retain their illegal gains. Liebman v. J.E. Petersen Coal and Oil Co., 73

F.R.D. 531 (N.D. Ill. 1973). Further, the settlement was not the result of good-faith bargaining between the attorneys; and in light of the amount offered in settlement balanced against the damages recoverable upon trial, the settlement was patently inadequate.

CONCLUSION

For these reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted,

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